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Security Interests

Draft Legislative Guide on Secured Transactions

Security rights in rights to payment of funds credited to a bank account, proceeds under an independent undertaking, negotiable instruments and negotiable documents

Note by the Secretariat*

Addendum

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* This document is submitted later than the required ten weeks prior to the start of the meeting because of the need to include changes decided at the tenth session of the Working Group held in New York from 1 to 5 May 2006. The numbering of the recommendations is not consecutive, as this document contains asset-specific recommendations taken from several chapters of the draft Guide.

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I. Security rights in rights to payment of funds credited to a bank account

[*Note to the Commission: In the context of its discussion of security rights in rights to payment of funds credited to a bank account, the Commission may wish to consider definitions (ff) ("bank account") and (gg) ("control") (see A/CN.9/WG.VI/WP.27/Add.1). The Commission may also wish to note that the commentary will explain that the term "bank account" does not include accounts held by central banks or payment, clearing and settlement institutions. The commentary will also explain that the secured creditor has control by becoming the account holder where: (i) an existing account is transferred to the secured creditor, (ii) the secured creditor agrees with the grantor that funds should be deposited to an account to be opened later, and (iii) the secured creditor is the only account holder (i.e. not merely a joint account holder).*]

Creation of a security right in a right to payment of funds credited to a bank account

[*Note to the Commission: The Commission may wish to note that the commentary will explain that, pursuant to recommendation 8 (see A/CN.9/WG.VI/WP.26/Add.7), a security right in a right to payment of funds credited to a bank account may be created by agreement between the grantor and the secured creditor.*]

26. The law should provide that a security right in a right to payment of funds credited to a bank account is effective notwithstanding an agreement between the grantor and the depositary bank limiting in any way the grantor's right to create a security right in its right to payment of funds credited to the bank account. However, the depositary bank has no duty to recognize the secured creditor and no obligation is otherwise imposed on the depositary bank with respect to the security right, without the depositary bank's consent.

[*Note to the Commission: The Commission may wish to note that the commentary to recommendation 3 (a) (see A/CN.9/WG.VI/WP.26/Add.7) will clarify that enacting States may wish to take into account any impact that the recommendations in this Guide might have on consumer-protection law.*]

Rights and obligations of the depositary bank

V. The law should provide that:

(a) The creation of a security right in a right to payment of funds credited to a bank account does not affect the rights and obligations of the depositary bank without its consent; and

(b) The rights of set-off of the depositary bank are not impaired by reason of any security right that the depositary bank may have in a right to payment of funds credited to a bank account.

[*Note to the Commission: The Commission may wish to note that the commentary will explain that recommendations V and W are supplemented by recommendations 76, 77 (to the extent that there is a priority conflict between a security right or right of set-off of the depositary bank and a security right of*

another person) and 106 bis, 107 and 108 (enforcement against the depositary bank).

The commentary will also explain that recommendation V (b) does not deal with a priority conflict but with the situation where the depositary bank itself has both a right of set-off against and a security right in a right to payment of funds credited to a bank account. In this situation, according to recommendation V (b), the bank's rights of set-off are not impaired or subsumed into (i.e. they remain distinct from) the bank's security right.]

W. The law should provide that nothing in these recommendations obligates a depositary bank to:

(a) Pay any person other than a person that has control with respect to funds credited to a bank account; or

(b) Respond to requests for information about whether a control agreement or a security right in its own favour exists and whether the grantor retains the right to dispose of the funds credited in the account.

[*Note to the Commission: The Commission may wish to note that the commentary will explain that recommendation W does not affect the bank-customer relationship and the rights and obligations arising from other law governing bank accounts (e.g. money-laundering and bank secrecy).*]

Third-party effectiveness of a security right in a right to payment of funds credited to a bank account

43. The law should provide that a security right in a right to payment of funds credited to a bank account is effective against third parties also if the secured creditor obtains control with respect to the right to payment of the funds credited to the bank account.

[*Note to the Commission: The Commission may wish to note that the commentary will explain that, pursuant to recommendation 35 (see A/CN.9/WG.VI/WP.26/Add.5), a security right in a right to payment of funds credited to a bank account may also become effective against third parties by registration of a notice in the general security rights registry.*]

Priority of a security right in a right to payment of funds credited to a bank account

76. The law should provide that a security right in a right to payment of funds credited to a bank account, which has been made effective against third parties by control, has priority over a security right in a right to payment of the funds, which has been made effective against third parties by any other method. If a depositary bank has concluded more than one control agreement, among those secured creditors, priority is determined according to the order in which the control agreements were concluded. If the secured creditor is the depositary bank, the depositary bank's security right has priority over any other security right (including a security right made effective against third parties by a control agreement with the depositary bank even if the depositary bank's security right is later in time) other than a security right of a secured creditor who has acquired control with respect to

the right to payment of the funds credited to the bank account by becoming the account holder.

[*Note to the Commission: The Commission may wish to note that the commentary will explain that a security right of the depositary bank always has priority even over a security right with respect to which the depositary bank has earlier entered into a control agreement because: (i) a security right of the depositary bank should have the same priority as its set-off right, which has always priority; (ii) if the depositary bank's security right had no priority, the bank would not enter into any control agreement; (iii) a secured creditor could always seek to obtain a subordination agreement from the depositary bank. The commentary will also explain that, depending on the terms of the control agreement, the depositary bank may have a contractual obligation to a secured creditor with a control agreement even though the secured creditor might not have priority.*

In addition, the Commission may wish to note that, at its tenth session, the Working Group agreed that tracing of funds credited to a bank account will be discussed together with the issue of tracing of proceeds (see A/CN.9/603, para. 67). The Commission may wish to deal with that issue as an issue of priority. The commentary to recommendation 76 will make clear that, if a secured creditor has control of a right to payment of funds credited to a bank account, its security right has priority over a security right in cash proceeds of an encumbered asset of another secured creditor that are credited to the same bank account, even if the other secured creditor is able to trace proceeds to the bank account. This is the case even if the competing security right became effective against third parties earlier than the security right held by the secured creditor with control.]

77. The law should provide that any right of the depositary bank to set-off against the right to payment of funds credited to a bank account obligations owed to the depositary bank by the grantor has priority over the security right of any secured creditor other than a secured creditor that has acquired control with respect to the funds credited to the bank account by becoming the account holder.

[*Note to the Commission: The Commission may wish to note that the commentary will explain that these priority recommendations mean that third parties are taken to know that they cannot rely on a right to payment of funds credited to a bank account as a primary source of security for extensions of credit and can do so only by obtaining a subordination agreement from the depositary bank or having the account entered in their own name. Consequently, the absence of publicity of the security right is not seen as problematic. The commentary will also explain that, unlike recommendation V (b), recommendation 77 deals with priority conflicts between rights of set-off of the depositary bank and security rights of other persons. In addition, the commentary will explain that recommendation 77 does not create any rights of set-off, a matter which remains subject to other law. Moreover, the commentary will explain that the exception in recommendation 77 refers to a secured creditor that acquired control by becoming the sole account holder. Where the secured creditor would be just a joint account holder, the grantor will still be able to dispose of the funds credited to the account and thus the secured creditor would not have control (see definition of "control" in A/CN.9/WG.VI/WP.27/Add.1).*]

78. In the case of a transfer of funds from a bank account initiated by the grantor, the law should provide that the transferee of the funds takes free of a security right in the right to payment of funds credited to the bank account, unless the transferee had knowledge that the transfer violated the terms of the security agreement. This recommendation does not lessen the rights of transferees of funds from bank accounts under law other than this law.

[*Note to the Commission: The Commission may wish to note that the commentary will explain that the general priority recommendations apply to security rights in rights to payment of funds credited to a bank account subject to recommendations 76 to 78. The Commission may wish to note that recommendation 79 (see A/CN.9/WG.VI/WP.26/Add.6) may have to be aligned with recommendation 78 to refer to knowledge rather than collusion.*]

Enforcement of a security right in a right to payment of funds credited to a bank account

106 bis. The law should provide that after default, or before default with the agreement of the grantor, a secured creditor with a security right in a right to payment of funds credited to a bank account is entitled, subject to recommendations V and W, to collect or otherwise enforce its right to payment of the funds.

107. The law should provide that after default, or before default with the agreement of the grantor, a secured creditor that has control with respect to a right to payment of funds credited to a bank account is entitled, subject to recommendations V and W, to enforce its security right without having to apply to a court or other authority.

[*Note to the Commission: The Commission may wish to note that the commentary will explain that, unlike a secured creditor that has to collect the funds to apply them to the secured obligation according to recommendation 116 (see A/CN.9/611), a depositary bank as a secured creditor may apply the funds to the secured obligation directly. The commentary will also explain that enforcement of the bank's rights of set-off remains subject to other law.*]

108. The law should provide that a secured creditor that does not have control with respect to funds credited to a bank account is entitled, subject to recommendations V and W, to collect or otherwise enforce the security right against the depositary bank only pursuant to a court order, unless the depositary bank agrees otherwise.

Law applicable to a security right in a right to payment of funds credited to a bank account

139. Except as otherwise provided in recommendation 140, the law should provide that the creation, the effectiveness against third parties, the priority over the rights of competing claimants, the rights and duties of the depositary bank with respect to the security right and the enforcement of the security right in a right to payment of funds credited to a bank account are governed by

Alternative A

the law of the State expressly stated in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law. However, the law of the State determined pursuant to the preceding sentence applies only if the depositary bank has, at the time of the conclusion of the account agreement, an office in that State which is engaged in the regular activity of maintaining bank accounts. The law should also specify that, if the applicable law is not determined pursuant to the preceding two sentences, the applicable law is to be determined pursuant to fallback rules based on article 5 of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.

[*Note to the Commission: Alternative A is an abbreviated version of the approach followed in articles 4.1 and 5 of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held With An Intermediary ("the Hague Securities Convention"). The commentary will include the detailed fallback rules in article 5 of the Hague Securities Convention with sufficient explanation.*]

Alternative B

the law of the State in which the bank that maintains the bank account has its place of business. In the case of more than one place of business, reference should be made to the place where the branch maintaining the account is located.

[*Note to the Commission: The Commission may wish to consider, as an alternative or supplementary provision, the law governing the control agreement (see A/CN.9/603, para. 77). The Commission may also wish to note that the commentary will explain that the recommendations on the impact of insolvency on the law applicable, as well as the other general recommendations in the conflict-of-laws chapter (A/CN.9/WG.VI/WP.24), apply to security rights in rights to payment of funds credited to a bank account.*]

II. Security rights in proceeds under an independent undertaking

[*Note to the Commission: In the context of its discussion of security rights in proceeds under an independent undertaking, the Commission may wish to consider definitions (z) ("independent undertaking"), (aa) ("proceeds under an independent undertaking"), (bb) ("guarantor/issuer"), (cc) ("confirmer"), (dd) ("nominated person") and (ee) ("control") (see A/CN.9/WG.VI/WP.27/Add.1).*]

Creation of a security right in proceeds under an independent undertaking

25. The law should provide that a beneficiary may grant a security right in proceeds under an independent undertaking, even if the right to draw under the independent undertaking is not itself transferable under law and practice governing independent undertakings. The grant of a security right in proceeds under an

independent undertaking is not a transfer of the right to draw under an independent undertaking.

[*Note to the Commission: The Commission may wish to note that the commentary will make clear that the second part of the first sentence makes clear the important point that transferability of an independent undertaking itself (i.e. the right to draw) is irrelevant to the right to create a security right in the proceeds under the independent undertaking. The commentary will also explain that the second sentence distinguishes a right to request payment under an independent undertaking from a right to receive the proceeds under an independent undertaking.*]

Rights and obligations of the guarantor/issuer, confirmer or nominated person of an independent undertaking

25 bis. The law should provide that:

(a) A secured creditor's rights in proceeds under an independent undertaking are subject to the rights, under the law and practice that govern independent undertakings, of the guarantor/issuer, confirmer or nominated person and of any other beneficiary named in the undertaking or to whom a transfer of drawing rights has been effected;

(b) The rights of a transferee-beneficiary of an independent undertaking are superior to a security right in proceeds under the independent undertaking acquired from the transferor [or any prior transferor]; and

(c) The independent rights of a guarantor/issuer, confirmer, nominated person or transferee-beneficiary under an independent undertaking are not impaired by reason of any security rights it may have in proceeds under the independent undertaking, including any right in proceeds under the independent undertaking that may result from a transfer of drawing rights to a transferee-beneficiary.

[*Note to the Commission: The Commission may wish to note that the commentary will make clear that this recommendation is intended to ensure that the rights of holders of independent rights to payment, notably nominated persons that have given value and transferee-beneficiaries to whom a transfer has been effected, are superior to mere assignees of rights to proceeds under a drawing by the original beneficiary. The commentary will also explain that their independent rights are distinct and are not impaired because of their rights as secured creditors of the original beneficiary (in other terms, their status as protected holders of independent rights should not be confused with their status as secured creditors). When a nominated person gives value and obtains reimbursement from the guarantor/issuer, it does so on the basis of its independent reimbursement rights and not as an acquirer of the rights of the beneficiary.*]

25 ter. Neither a guarantor/issuer nor a confirmer nor a nominated person is obligated to pay any person other than a named beneficiary, an acknowledged transferee-beneficiary or an acknowledged assignee of proceeds under an independent undertaking.

25 quater. The law should provide that, if a secured creditor has obtained control with respect to proceeds under an independent undertaking by becoming an acknowledged assignee of the proceeds, the secured creditor has the right to enforce

the acknowledgement against the guarantor/issuer, confirmer or nominated person that made the acknowledgement

Third-party effectiveness of a security right in proceeds under an independent undertaking

49. The law should provide that a security right in proceeds under an independent undertaking is made effective against third parties by control with respect to the proceeds under the independent undertaking.

[*Note to the Commission: The Commission may wish to note that recommendation 49 has been revised on the basis of the assumption that neither possession of an independent undertaking nor registration of a notice should be a method of achieving third-party effectiveness of a security right in a right to proceeds under an independent undertaking. Possession of an independent undertaking (even when it is in tangible form) plays only a limited role in the modern use of independent undertakings. In addition, if possession were included in this Guide as a method of achieving effectiveness against third parties, there would be a need for complex rules dealing with priority and conflict of laws. It should be noted, however, that, although possession does not constitute a method of achieving effectiveness against third parties, as a practical matter, possession would give protection to a secured creditor when the terms of the independent undertaking require the physical presentation of the independent undertaking to make a draw under the independent undertaking. In such a circumstance, the beneficiary could not make an effective draw without the secured creditor's cooperation, so the secured creditor could take steps to assure itself of payment (e.g. the secured creditor could require the beneficiary to obtain an acknowledgement that would achieve control for the secured creditor before surrendering the independent undertaking and allowing it to be presented to the guarantor/issuer or nominated person that gave the acknowledgement).*]

Priority of a security right in proceeds under an independent undertaking

62. The law should provide that a security right in proceeds under an independent undertaking, which has been made effective against third parties by control has, with respect to a particular guarantor/issuer, confirmer or nominated person agreeing to give value under an independent undertaking, priority over the rights of all other secured creditors who have not, with respect to that person, made their security right effective against third parties by control. If control has been achieved by acknowledgement and inconsistent acknowledgements have been given to more than one secured creditor by a person, among those secured creditors, priority is determined according to the order in which the acknowledgements were given.

[*Note to the Commission: The Commission may wish to note that the commentary will explain that, as the typical method of achieving control is by obtaining an acknowledgment, in the case of several potential payors (e.g. the guarantor/issuer, confirmer and several nominated persons), control is achieved only vis-à-vis the particular guarantor/issuer(s), confirmer(s) or nominated person(s) who gave the acknowledgment(s). Thus, the priority rule must focus on the particular person who is the payor. The basic priority rule makes clear that a secured creditor that has control of the right to proceeds under an independent undertaking has priority over a secured creditor whose security right became*

effective against third parties automatically. The commentary will also explain that the guarantor/issuer may have a contractual obligation to an acknowledged secured creditor even though the secured creditor might not have priority.]

Enforcement of a security right in proceeds under an independent undertaking

106. The law should provide that effectiveness against third parties of a security right in proceeds under an independent undertaking (whether achieved by control or automatically) is not a prerequisite to enforcing the security right. However, as against the guarantor/issuer, confirmer, nominated person or beneficiary other than the grantor, the security right must be exercised in accordance with recommendations 25 bis, 25 ter and 25 quater.

[*Note to the Commission: The Commission may wish to note that the commentary will make clear that no separate act of transfer by the grantor is necessary for the secured creditor to enforce a security right in a right to proceeds under an independent undertaking when the security right is created automatically under recommendation 16. The commentary will also explain that any obligations of the guarantor/issuer or nominated person to the secured creditor are governed by recommendations 25 bis, 25 ter and 25 quater. Furthermore, the commentary will explain that recommendation 106 is not intended to disturb any pre-default arrangements agreed upon between the grantor and the secured creditor by which, prior to the grantor's default, the secured creditor may receive the proceeds under an independent undertaking.*]

Law applicable to security rights in proceeds under an independent undertaking

138. The law should provide that: (i) the rights and duties of a guarantor/issuer, confirmer or nominated person that has received a request for an acknowledgement or that has or may pay or otherwise give value under an independent undertaking; (ii) the right to enforce a security right in proceeds under an independent undertaking against a guarantor/issuer, confirmer or nominated person; and (iii) except to the extent otherwise provided in recommendation 138 bis, the effectiveness against third parties and the priority over the rights of competing claimants of a security right in proceeds under the independent undertaking are governed, separately with respect to a particular guarantor/issuer, confirmer or nominated person, by the law of the State determined as follows:

(a) If the guarantor/issuer has issued an independent undertaking, the confirmer has issued a confirmation or the nominated person has issued an acknowledgement that specifies that it is governed by the law of a State, the applicable law is the law of the specified State;

(b) If the applicable law is not determined under the preceding paragraph, the applicable law is the law of the State of the location of the branch or office of the guarantor/issuer, confirmer or nominated person indicated in the independent undertaking of the guarantor/issuer, confirmer or nominated person. However, in the case of a nominated person that has not issued an independent undertaking, the applicable law is the law of the State of the location of the nominated person's branch or office that has or may pay or otherwise give value under the independent undertaking.

138 bis. The law should provide that, if a security right in proceeds under an independent undertaking is created and is made effective against third parties automatically as a result of the effectiveness against third parties of a security right in a receivable, negotiable instrument or other obligation which the independent undertaking secures, the creation and the effectiveness against third parties of the security right in the proceeds under the independent undertaking is governed by the law of the State whose law governs the creation and the effectiveness against third parties of the security right in the secured receivable, negotiable instrument or other obligation.

[*Note to the Commission: The Commission may wish to note that the commentary will explain that recommendation 138 follows the conflict-of-laws rules applicable with respect to the rights and obligations of guarantor/issuers, confirmers or nominated persons. The only exception to the principle embodied in recommendation 138 is recommendation 138 bis for the limited issues of creation and third-party effectiveness in the cases where a security right arises or is made effective against third parties automatically.*

In addition, the commentary will explain that each bank (or sometimes non-bank) filling one of these roles acts pursuant to the law where it is located, meaning where its relevant branch or office is located (or the law it chooses, which is typically the law of the State where its relevant branch or office is located). Accordingly, different laws govern the different banks involved, and a choice of law in an independent undertaking governs only the particular issuer's obligations (see URDG article 27, UCC 5-116 (b), and United Nations Assignment Convention article 29). The commentary will also explain that what recommendation 138 strives to do is be clear that a request for acknowledgement or for payment (without prior acknowledgement) made by a secured creditor (or the beneficiary on its behalf) is to be handled by the affected bank branch under its local law.

Under recommendation 138, all priority conflicts are subject to the law chosen by a guarantor/issuer, confirmer or nominated person or, in the absence of a choice of law, to the law of the relevant branch or office. The Commission may wish to consider the question whether: (i) if that bank branch pays (or gives value to) that secured creditor, then that same law should apply to that secured creditor's priority contest with third parties; and (ii), if the payment is to the beneficiary and the priority contest is among third parties, recommendation 138 should be inapplicable and residual conflict-of-laws rules apply (i.e. recommendation 137).

The commentary will further explain that: (i) creation of the security right is governed by the general conflict-of-laws rule in recommendation 137 for security rights in intangibles (except as provided in recommendation 138 bis for automatic creation); and (ii) enforcement of the security right is governed by the general conflict-of-laws rule in recommendation 148, except to the extent otherwise provided in recommendation 138.]

III. Security rights in negotiable instruments

[*Note to the Commission: In the context of its discussion of security rights in negotiable instruments, the Commission may wish to consider definitions (i) ("tangibles") and (x) ("negotiable instrument") (see A/CN.9/WG.VI/WP.27/Add.1).*]

Parties, security rights, secured obligations and assets covered

3. In particular, the law should provide that it applies to:

...

(f) Generally, outright transfers of receivables;

[*Note to the Commission: The Commission may wish to note that, at its tenth session, the Working Group agreed that, while outright transfers of negotiable instruments should not be covered in the draft Guide, a discussion of the relevant issues might be included in the commentary for the benefit of States that might wish to address outright transfers of negotiable instruments because of their importance to financing practices (see A/CN.9/603, para. 50).*

In that connection, the Commission may wish to note that the commentary will explain that, while principles of secured transactions law can easily be made to apply to the outright transfer of promissory notes and, perhaps, bills of exchange other than cheques, in a manner similar to this Guide's coverage of the outright transfer of receivables, those principles do not apply well to the outright transfer of cheques. The latter topic is sufficiently covered by the law of negotiable instruments and the law of bank collections.

The commentary will also explain that an enacting State that wishes to expand the scope of its secured transactions law to apply to outright transfers of negotiable instruments that are either promissory notes or bills of exchange (and to expand its definition of "security right" to cover the right of the transferee in such a transaction) might wish to consider providing that a security right that is an outright transfer of such a negotiable instrument is automatically effective against third parties upon the transfer. Such a rule would avoid disrupting existing financial practices.

In addition, the commentary will explain that, with respect to the priority of such a security right, the general principles of priority would apply. Most particularly, the general principle in recommendation 63 (see A/CN.9/WG.VI/WP.26/Add.6), as qualified by recommendation 74, would govern. As in the case of an outright transfer of a receivable, the outright transferee of such a negotiable instrument should be able to enforce the instrument without further consent of the assignor subject, of course, to the rights of the obligors on the negotiable instrument as described in the chapter on enforcement.]

Creation of a security right in a negotiable instrument

[*Note to the Commission: The Commission may wish to note that the commentary will explain that, pursuant to recommendation 8 (see A/CN.9/WG.VI/WP.26/Add.7), a security right in a negotiable instrument may be*

created by a written and possibly signed agreement between the grantor and the secured creditor or by even an oral agreement and delivery of possession of the instrument to the secured creditor. The commentary will also explain that creation of a security right under this recommendation will not affect rights obtained by endorsement of the negotiable instrument under the law governing negotiable instruments.]

Rights and obligations of the obligor under a negotiable instrument

X. The law should provide that, as between the secured creditor and (i) the person obligated on the negotiable instrument or (ii) other persons claiming rights under the law governing negotiable instruments, the obligations and rights of those persons are determined by the law governing negotiable instruments.

Third-party effectiveness of a security right in a negotiable instrument

[*Note to the Commission: The Commission may wish to note that the commentary will explain that, according to the general third-party effectiveness recommendation 35 (see A/CN.9/WG.VI/WP.26/Add.5), a security right in a negotiable instrument may be made effective against third parties by registration of a notice in the general security rights registry. Recommendation X addresses a special issue.*]

Y. The law should provide that a security right in a negotiable instrument that was made effective against third parties by dispossession continues to be effective against third parties for a short period of [to be specified] days after the negotiable instrument has been relinquished to the grantor for the purpose of presentation, collection, enforcement or renewal.

[*Note to the Commission: The Commission may wish to note that a secured creditor may have to return an encumbered negotiable instrument to the grantor for presentation, collection, enforcement or renewal, if the secured creditor does not have that right. The commentary will also explain that, by returning the encumbered negotiable instrument to the grantor, the secured creditor would be exposed to the risk of losing its security only for a short period of time and only if it had not registered a notice about its security right in the general security rights registry.*]

Priority of a security right in a negotiable instrument

[*Note to the Commission: The Commission may wish to note that the commentary will explain that the general priority recommendations (see A/CN.9/WG.VI/WP.26/Add.6) apply to priority with respect to security rights in negotiable instruments, while recommendations 74 and 74 bis deals with additional priority conflicts.*]

74. The law should provide that a security right in a negotiable instrument that was made effective against third parties by dispossession of the grantor with respect to the instrument has priority over a security right in a negotiable instrument that was made effective against third parties by any other method.

74 bis. The law should provide that a security right in a negotiable instrument that was made effective against third parties by a method other than by dispossession of

the grantor with respect to the instrument is subordinate to the rights of another secured creditor, buyer or other transferee (in a consensual transaction) that either:

(a) Qualifies as a protected holder under the law governing negotiable instruments; or

(b) Takes possession of the negotiable instrument and gives value in good faith and without knowledge that the transfer was in violation of the rights of the holder of the security right.

Enforcement of a security right in a negotiable instrument

104. The law should provide that after default, or before default with the agreement of the grantor, the secured creditor, is entitled, subject to recommendation X, to collect or otherwise enforce a negotiable instrument that is an encumbered asset against a person obligated on that instrument.

[*Note to the Commission: The Commission may wish to note that commentary will explain that as between the secured creditor and (i) the person obligated on the negotiable instrument, or (ii) other persons claiming rights under the law governing negotiable instruments, the enforcement rights of the secured creditor are subject to the law governing negotiable instruments. The commentary will also include the following examples of such persons:*

(a) The person obligated on the negotiable instrument may be obligated to pay only a holder or other person entitled to enforce the instrument under the law governing negotiable instruments; and

(b) The right of the person obligated on the instrument to raise defences to that obligation is determined by the law governing negotiable instruments.]

105. The law should provide that the secured creditor's right to collect or otherwise enforce a negotiable instrument includes the right to collect or otherwise enforce any personal or property right that secures payment of the negotiable instrument (such as a guarantee or security right).

Law applicable to security rights in tangibles

136. The law should provide that, except as otherwise provided in recommendations 140 and 142, the creation, the effectiveness against third parties and the priority over the rights of competing claimants of a security right in tangible property are governed by the law of the State in which the encumbered asset is located. However, with respect to security rights in tangible property of a type ordinarily used in more than one State, the law should provide that such issues are governed by the law of the State in which the grantor is located. [With respect to security rights in the type of tangible property mentioned in the preceding sentence that is subject to a title registration system, the law should provide that such issues are governed by the law of the State under the authority of which the registry is maintained.]

[*Note to the Commission: The Commission may wish to note that the commentary will explain that "tangible property of a type ordinarily used in more than one State" refers to mobile goods, such as motor vehicles. The same term in*

the bracketed sentence in recommendation 136 refers to mobile goods, such as ships and aircraft.]

Law applicable to third-party effectiveness of security rights in specified types of asset by registration

140. If the State in which the grantor is located recognizes registration as a method of achieving effectiveness against third parties of a security right in a negotiable instrument and rights to payment of funds credited to a bank account, the law of that State determines whether the effectiveness against third parties of a security right in such encumbered assets has been achieved by registration under the laws of that State.

Law applicable to the rights and obligations of the grantor and the secured creditor

146. [*See A/CN.9/611.*]

Law applicable to the rights and obligations of the debtor of the receivable and the assignee, the obligor under a negotiable instrument or the issuer of a negotiable document and the secured creditor

147. [*See A/CN.9/611.*]

[*Note to the Commission: The Commission may wish to note that the commentary will explain that: (i) recommendation 148 applies to the enforcement of a security right in a negotiable instrument (A/CN.9/WG.VI/WP.24); and (ii) the recommendations on the impact of insolvency on the law applicable, as well as the other general recommendations in the conflict-of-laws chapter (A/CN.9/WG.VI/WP.24), apply to security rights in negotiable instruments.*]

IV. Security rights in negotiable documents

[*Note to the Commission: In the context of its discussion of security rights in negotiable documents, the Commission may wish to consider definitions (y) ("negotiable document"), (nn) ("possession") and (oo) ("issuer") (see A/CN.9/WG.VI/WP.27/Add.1).*]

Creation of a security right in a negotiable document

[*Note to the Commission: The Commission may wish to note that, the commentary will explain that, pursuant to recommendation 8 (see A/CN.9/WG.VI/WP.26/Add.7), a security right in a negotiable document may be created by a written and possibly signed agreement between the grantor and the secured creditor or even by an oral agreement and delivery of possession of the document to the secured creditor. For the benefit of enacting States that may wish to consider addressing multi-modal transport documents, the commentary will explain that, as the definition of a negotiable document in the draft Guide is left to the law governing negotiable documents, the negotiability of multi-modal transport documents is also left to that law.*]

28. The law should provide that the creation of a security right in a negotiable document also gives rise to a security right in the goods represented by the document, provided that the issuer is in possession of the goods, directly or indirectly, at the time the security right in the document is created.

[*Note to the Commission: The Commission may wish to note that the commentary will clarify that a security right in goods covered by a negotiable document may be created pursuant to recommendation 8 directly in the goods or pursuant to recommendation 28 through the creation of a security right in the negotiable document covering the goods. The commentary will also clarify that recommendation 28 is intended to negate that, in situations where a security right exists in a negotiable document, a separate security right needs to be created in the goods covered by the document. Moreover, the commentary will explain that neither recommendation 8 nor recommendation 28 nor any other recommendation affects rights in negotiable documents acquired under the law governing negotiable documents.*]

Rights and obligations of the issuer of a negotiable document

Z. The law should provide that as between the secured creditor and the issuer or other person obligated on the negotiable document, the rights and obligations of those persons are determined by the law governing negotiable documents.

[*Note to the Commission: The Commission may wish to note that this recommendation will be placed in a separate chapter dealing with the rights and obligations of third-party obligors.*]

Third-party effectiveness of a security right in a negotiable document

44. The law should provide that a security right in a negotiable document is made effective against third parties by delivery of possession of the document to the secured creditor.

44 bis. The law should provide that, if a security right in a negotiable document is effective against third parties, the corresponding security right in the goods covered by the document is also effective against third parties. As long as a negotiable document covers goods, a security right in the goods may be made effective against third parties by dispossession of the grantor with respect to the document.

44 ter. The law should provide that a security right in a negotiable document that was made effective against third parties by dispossession of the grantor remains effective against third parties for a short period of [to be specified] days after the negotiable document has been relinquished to the grantor or other person for the purpose of ultimate sale or exchange, loading or unloading, or otherwise dealing with the goods covered by the negotiable document.

Priority of a security right in a negotiable document

[*Note to the Commission: The Commission may wish to note that the commentary will clarify that the general priority recommendations apply to security rights in negotiable documents, while recommendations 80 and 81 deal with additional priority conflicts.*]

80. The law should provide that, while goods are in the possession of the issuer of a negotiable document with respect to them, a security right in those goods that became effective against third parties as a result of the security right in the negotiable document becoming effective against third parties has priority over another security right in the goods that was made effective against third parties by a different method while the goods were covered by the document.

81. The law should provide that a security right in a negotiable document and the goods covered thereby is subject to the rights under the law governing negotiable documents of a person to whom the negotiable document has been duly negotiated.

Enforcement of a security right in a negotiable document

[*Note to the Commission: The Commission may wish to note that the commentary will also explain that the general recommendations on enforcement of security rights apply here as well, while recommendation 109 deals with a special issue.*]

109. The law should provide that after default, or before default with the agreement of the grantor, the secured creditor is entitled, subject to recommendation Z, to enforce a security right in negotiable document against the issuer or any other person obligated on the negotiable document.

[*Note to the Commission: The Commission may wish to note that the commentary will explain that, under law governing negotiable documents, the issuer may be obligated to deliver the goods only to a holder of the negotiable document with respect to them.*]

Law applicable to security rights in tangibles

136. [*See recommendation 136 under III above.*]

[*Note to the Commission: The Commission may wish to note that a security right may be created in goods either pursuant to recommendation 8 or by the creation of a security right in a negotiable document representing those goods pursuant to recommendation 28 (see above). In either case, recommendation 136 provides that the creation, third-party effectiveness and priority of the security right are governed by the law of State of the location of the goods or document, as applicable. Because goods in transit and export goods, by their nature, move from State to State and, therefore, the location of the goods at any particular moment might be fortuitous and temporary, recommendation 142 provides an alternative method for creation and third-party effectiveness of a security right in such goods referring to the law of the State of the ultimate destination of the goods, provided that the goods reach that destination within a reasonable period of time. Recommendation 142 thus addresses the problems that could result from unwavering adherence to the "location of the tangible asset rule" in the context of goods whose location will certainly change as a result of the very nature of the financing transaction.*

The Commission may also wish to note, though, that, at its tenth session, the Working Group considered that, in many financing transactions involving negotiable documents it is also the nature of the transaction that the location of the negotiable document changes, as, for example, a bill of lading may move from the

consignor to the consignee to the secured creditor or other financier (see A/CN.9/603, para. 60). In addition, the Working Group noted that, in such transactions, at any particular time the negotiable document might be located in a different State than the goods that it represents, even though the goods and the negotiable document will ultimately be located in the same State. Accordingly, at that session, the suggestion was made that the practical issue with respect to the goods that is addressed by recommendation 142 might also be present for the negotiable documents representing those goods and that, accordingly, there may be some advantage in broadening the rule in recommendation 142 to cover negotiable documents. Thus, the Commission may wish to consider extending the application of recommendation 142 to negotiable documents. In that connection, the Commission may wish to take into consideration that, under recommendations 136 and 142, the priority of a security right in goods covered by a negotiable document is always subject to the law of the location of the document. If the applicable law is the law of a State that has enacted the recommendations of this Guide, under recommendation 80, the security right in the goods that became effective against third parties as a result of the security right in the negotiable document becoming effective against third parties will have priority over a security right in the goods that became effective against third parties by another method. The Commission may also wish to note that, under recommendation 148, the enforcement of the security right in the goods or the document is always subject to the law of the State where enforcement takes place or the law governing the security agreement (depending on which alternative is retained).]

Law applicable to third-party effectiveness of security rights in specified types of asset by registration

140. [*See recommendation 140 under III above.*]

Security rights in goods in transit and export goods

142. The law should provide that a security right in tangible property (other than negotiable instruments or negotiable documents) in transit or to be exported from the State in which it is located at the time of the creation of the security right may also be created and made effective against third parties under the law of the State of the ultimate destination, provided that the property reaches that State within a short time period of [to be specified] days after the time of creation of the security right.

[*Note to the Commission: The Commission may wish to note that the commentary will explain that a security right in goods in transit and export goods can be created and made effective against third parties, under recommendation 136, in accordance with the law of the State of their location at the time of creation, or, under recommendation 142, in accordance with the law of the State of their ultimate destination. The commentary will also explain that the law of the State of the ultimate destination that governs creation and third-party effectiveness will apply even in the case of a contest with competing rights that were created and made effective against third parties while the export goods were located in the State of origin. In addition, the commentary will explain that the rule in this recommendation: (i) is applicable to encumbered assets that travel whether or not negotiable documents relating to the goods accompany the goods; (ii) is not applicable to encumbered goods that do not travel, whether or not negotiable*

documents relating to the goods do travel; and (iii) is not applicable to encumbered negotiable documents whether or not they travel.]

Law applicable to the rights and obligations of the grantor and the secured creditor

146. [*See A/CN.9/611.*]

Law applicable to the rights and obligations of the debtor of the receivable and the assignee, the obligor under a negotiable instrument or the issuer of a negotiable document and the secured creditor

147. [*See A/CN.9/611.*]

[*Note to the Commission: The Commission may wish to note that the commentary will explain that: (i) recommendation 148 applies to the enforcement of a security right in a negotiable document (A/CN.9/WG.VI/WP.24); and (ii) the recommendations on the impact of insolvency on the law applicable, as well as the other general recommendations in the conflict-of-laws chapter (A/CN.9/WG.VI/WP.24), apply to security rights in negotiable documents.*]